INDEX

CITATIONS

Cases:

666841—62——1

In the Supreme Court of the United States

OCTOBER TERM, 1962

No.—

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CAPITAL GAINS RESEARCH BUREAU, INC., AND HARRY P. SCHWARZMANN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Securities and Exchange Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit *en banc*, entered on July 13, 1962, which affirmed by a 5–4 vote the order entered on March 1, 1961, by the United States District Court for the Southern District of New York.

OPINIONS BELOW

The opinion of the district court (R. 38–40)[1] is reported at 191 F. Supp. 897. The opinions of a panel

[1] Citation is to the Appendix to the Brief of the Securities and Exchange Commission in the court of appeals which is Volumn I of the two-volume record certified by the Clerk of the Court of Appeals for the Second Circuit. Nine additional copies of this Appendix are being filed herewith.

of the court of appeals (App. A, *infra*, pp. 1a–12a; 12a–17a) are reported at 300 F. 2d 745. The opinions of the court of appeals upon rehearing *en banc* (App. A, *infra*, pp. 18a–27a; 27a–45a) are not yet reported.

JURISDICTION

The judgment of the court of appeals *en banc* was entered on July 13, 1962 (App. B, *infra*, p. 46a). The time to file a petition for a writ of certiorari has been extended to November 26, 1962, upon timely applications for extensions granted by orders of Mr. Justice Harlan entered October 18, and November 6, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the practice commonly known in the investment business as "scalping"—the purchase by an investment adviser of a stock just prior to his widespread recommendation of the stock to his clients, followed by the sale of the stock at a profit upon the rise in the market price which customarily follows such recommendations, without disclosure of his personal interest—is a "device, scheme, or artifice to defraud," or a "practice * * * which operates as a fraud or deceit" upon the investment adviser's clients in violation of Section 206 (1) and (2) of the Investment Advisers Act of 1940.

STATUTES INVOLVED

Prior to its amendment in 1960 (see, *infra*, p. 18), Section 206 of the Investment Advisers Act of 1940,

54 Stat. 847, 15 U.S.C. (1958 ed.) 80b–6 provided in pertinent part:

> It shall be unlawful for any investment adviser * * *, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> * * * * *

Other relevant statutory provisions are set forth in Appendix C, *infra*, pp. 47a–49a.

STATEMENT

The respondent Capital Gains Research Bureau, Inc., is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers' Act of 1940. The company is operated by respondent Harry P. Schwarzmann, its president and principal stockholder (R. 9). The principal business of Capital Gains is the publication of two investment advisory services. The one involved in this case is called "A Capital Gains Report," and is described as "An Investment Service devoted exclusively to (1) The protection of investment capital, (2) The realization of a steady and attractive income therefrom, (3) The accumulation of CAPITAL GAINS thru the timely purchase of corporate equities that are proved to be undervalued" (R. 30). The service consists of a monthly bulletin (see R. 47) in which respondents evaluate and recommend the pur-

chase of a single specific security (R. 30-32). In so doing respondents may evaluate and report adversely on securities of comparable enterprises. The Report is issued to approximately 5,000 subscribers, who pay $18.00 per year for the service, and is frequently distributed without charge to as many as 100,000 non-subscribers whose names appear on mailing lists (R. 9, 10).

During the period from March 15, 1960, through November 7, 1960, respondents on six different occasions purchased a particular security and shortly issued a Capital Gains Report recommending the security for long-term investment. In each instance, the market price rose within a few days after distribution of respondents' bulletin. Respondents then sold the shares at a profit. In one instance respondents profited not only from the purchase, recommendation and sale of a security (Frank G. Shattuck Co.), but also from selling short a security which they then stated was overpriced (Chock Full O'Nuts). Prior to the issuance of this bulletin, they had purchased three-month calls on the Shattuck stock and had sold short stock of Chock Full O'Nuts. After publication of the bulletin, when the price of the Shattuck stock had risen and that of the Chock Full O'Nuts stock had declined, respondents exercised their call options on the former and covered their short sales of the latter, in each instance at a profit.

The timing and profits of respondents' purchases, recommendations and sales of the seven securities may be summarized as follows (R. 9–25):

Stock	Purchased	Recommended	Sold	Profit
Continental Insurance Co.	3/15/60	3/18/60	3/29/60	[1] $1,125.00
United Fruit Co.	5/13, 16, 19, 20/60	5/27/60	6/6, 7, 9, 10/60	$10,725.00
Creole Petroleum Corp.	7/5, 14/60	7/15/60	7/20, 21, 22/60	[1] $1,762.50
Hart, Schaffner & Marx.	8/8/60	8/12/60	8/18, 22/60	$837.00
Union Pacific	10/28, 31/60	11/1/60	11/7/60	$1,757.00
Frank G. Shattuck Co.	10/11/60 (purchased calls).	10/14/60	10/25/60 (exercised calls)	$695.17
Chock Full O' Nuts	10/4/60 (sold short)	10/14/60 (disparaged)	10/24/60 (covered)	$2,772.33

[1] Since the exact prices at which these transactions occurred are not given, this figure represents the minimum profit as computed upon the highest possible market purchase price and the lowest possible market selling price on the days in question.

Respondents did not disclose any aspect of any of the foregoing transactions to their clients (R. 14).

In November 1960, the Commission commenced an action in the district court alleging that respondents had "employed devices, schemes and artifices to defraud clients * * * and prospective clients" and "engaged in transactions, practices and courses of business which operate and have operated as a fraud and deceit" upon such clients in violation of Section 206 (1) and (2) of the Investment Advisers Act (R. 1–4). The Commission sought an injunction to require respondents to disclose the material facts concerning their practices as part of any future bulletin (R. 3–4). The district court denied a preliminary injunction, holding that the foregoing facts did not establish a violation of the statute.[2] On ap-

[2] The district court determined that the words "fraud" and "deceit" were used in Section 206 in a "technical sense" and

peal, a panel of the court of appeals, one judge dissenting, affirmed (App. A, *infra*, pp. 1a–12a; 12–17a). Subsequently, the court *en banc* reaffirmed the district court's order in a 5–4 decision.[3]

While recognizing (App. A, *infra*, p. 21a) that the "federal securities laws are to be construed broadly to effectuate their remedial purpose" and that "a relationship of trust and confidence should exist between the advisor and the advised," the majority held that respondents had not violated their fiduciary duty to their clients by failing to disclose their holdings of the stocks recommended and their practice of selling those securities shortly after their recommendations, and thus profiting "personally from the predictable market effect of [their] honest advice." The court held that the statute requires the Commission to prove that the individual security recommendations were made in bad faith, and the court refused to infer bad faith from respondents' practice. The majority indicated that if, at the trial, the Commission were able to establish that the respondent firm made its recommendations "for the purpose of endeavoring artificially to raise the market so that it might unload its holdings at a profit, such

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required proof either that respondents intended that their clients lose money or that the clients had in fact suffered losses as a result of respondents' advice (R. 39).

[3] The opinion of the court *en banc* (App. A., infra, pp 18a–27a) was written by Judge Moore and joined in by Chief Judge Lumbard and Judges Waterman, Friendly and Hays; the dissenting opinion (App. A, *infra*, pp. 27a–45a), written by Judge Clark, was joined in by Judges Smith, Kaufman and Marshall.

conduct might well find itself within the prohibitions of Section 206 (1) and (2)". (*ibid.*).

The four dissenters criticized the majority's "uniquely strict interpretation" of the Investment Advisers Act of 1940, "the last of the six great regulatory statutes governing dealings in investments" (App. A, *infra*, p. 27a). They stated (App. A, *infra*, p. 40a):

> Here Capital Gains held itself out as an investment adviser and stated that the service was exclusively designed to help clients protect investment capital, realize income, and accumulate capital gains. It thus naturally installed in its clients the belief that it would render impartial and unbiased expert advice. Having taken this fiduciary stance, it then secretly engaged in profitable trading operations often inconsistent with its own advice. These operations were dependent for their success on client and general market reaction to the advice, and thus gave Capital Gains a motive to encourage purchases by its clients, regardless of the stock's intrinsic merit. Failure to disclose the existence of such a motive in the light of the implicit and explicit guaranty of impartiality was a scheme to defraud and operated as a fraud upon the clients.

REASONS FOR GRANTING THE WRIT

This case, the first to come before the Court under the Investment Advisers Act of 1940, presents a question of statutory interpretation important in protecting the public against fraud. Section 206 (1) and (2) of the Act makes it unlawful for an investment

adviser "to employ any device, scheme, or artifice to defraud," or "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon," any actual or prospective client. The question is whether an investment adviser violates these provisions by engaging in the practice known as "scalping," *i.e.,* trading on the predictable market effect of his investment advice, for example, as here, purchasing securities immediately prior to recommending them to his clients and then selling at the profit made possible by the predictable market rise resulting from his recommendation, all without disclosure to the clients.

As the dissenting opinion below pointed out, the Investment Advisers Act "was designed to protect 'the public' 'from the frauds and misrepresentations of unscrupulous tipsters and touts' and to safeguard bona fide investment counsel 'against the stigma of the activities of these individuals.' "[4] The decision of the majority, by sanctioning the practice of scalping, seriously weakens the effectiveness of the Act in protecting the investing public against such unscrupulous activities. As the dissent noted, it "sanctions and indeed endorses a low standard of business morality" (App. A, *infra,* pp. 36a, 45a). It would also have an inhibiting effect upon the interpretation and enforcement of the antifraud provisions of other federal securities statutes[5] which are cast in the same

[4] App. A, *infra,* p. 36a. The dissent is quoting from S. Rep. No. 1775, 76th Cong., 3d Sess., p. 21.

[5] See, *e.g.,* Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a).

terms and which have never been construed by this Court.[6] The importance of this decision to the future administration of the federal securities laws is particularly serious since the Second Circuit encompasses the nation's largest financial community and the center of the country's securities industry.[7]

1. The majority opinion sanctions a breach of the fiduciary duty which an investment adviser owes to his clients. This duty requires disinterested advice and disclosure of all material facts which the client may need to evaluate the advice. (See cases cited and discussed, *infra*, pp. 11–15). Section 206 (1) and (2) of the Investment Advisers Act incorporates this standard of conduct as part of its proscription of fraud and deceit.[8] In holding that this duty of disinterested ad-

[6] In disregarding earlier opinions construing these securities laws, which are in *pari materia* with the Investment Advisers Act, the decision below creates a conflict in principle with decisions of courts of appeals of other circuits, as well as of the court below, as to the breadth of the general anti-fraud provisions of these securities laws.

[7] Although the decision below determined the propriety of the district court's denial of a preliminary injunction, it rests not on the state of the record but upon the majority's interpretation of the substantive scope of Section 206 (1) and (2) of the Investment Advisers Act. These circumstances are sufficient to warrant review of the interpretation of the statute without awaiting an order disposing of the entire case. Cf. *Hanover Star Milling Co.* v. *Metcalf*, 240 U.S. 403, 408–409. The preliminary injunction is often the only effective weapon against infractions of the securities laws. By the time a permanent injunction can be obtained, the damage may be irreparable.

[8] The Commission's 1939 Report to the Congress, from which the Act stemmed, makes it clear that the Investment Advisers

vice and full disclosure is violated only if the Commission can prove that the investment advice was given in bad faith, the majority below disregarded this fiduciary relationship, the history and purpose of the securities laws, and the cases which have interpreted those laws.

It is a basic requirement of securities regulation that once a relationship of trust and confidence—a fiduciary relationship—exists, the fiduciary comes under a duty not to use that relationship secretly for personal profit. This is particularly so where, as here, a conflict between the financial interests of the fiduciary and his beneficiaries is created. In the present case, the existence of this fiduciary relationship is conceded in the majority opinion, as is the fact that the Commission's evidence "tends * * * to show" that respondents "profited personally from the predictable market effect of [their] honest advice" (App. A, *infra*, p. 21a). That respondents failed to disclose their practice of using their advice for personal profit is undenied. The conflict of interest in this situation is apparent, for the adviser's selection of securities

Act was passed to require advisers to eliminate conflicts of interest with their clients:

"Broadly stated, the representatives [of the investment counseling industry] felt that investment counsel organizations could not completely perform their basic function—furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments—unless all conflicts of interest between the investment counsel and the client were removed."

Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission—Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H. Doc. No. 477, 76th Cong., 2d Sess. p. 28.

to recommend or disparage may well be influenced—intentionally or unintentionally—by their relative adaptability to profitable "scalping." The fact that the opinions expressed are "honest" when given (*i.e.*, that the adviser believed the securities to be a desirable long-term investment)—or at least cannot later be shown to have been dishonest—in no way removes the conflict of interest or the duty of disclosure.

The holding of the majority below, that a fiduciary's failure to make a full disclosure of his personal interest is permissible as long as his advice is otherwise honest, is a departure from the high standard of fiduciary conduct which the courts have recognized as required by similar antifraud provisions of the other federal securities laws. Thus, in *Securities and Exchange Commission* v. *Torr*, 15 F. Supp. 315 (S.D.N.Y.), reversed on other grounds, 87 F. 2d 446 (C.A. 2), reaffirmed on remand, 22 F. Supp. 602, the district court held that the failure of securities dealers recommending a stock "solely on its merits" to disclose their financial interest in inducing clients to rely on their advice, violated Section 17(a) of the Securities Act of 1933 (15 U.S.C. 77q(a)), a general anti-fraud provision comparable to Section 206 (1) and (2) of the Investment Advisers Act. The main defendants in *Torr* held options on a large block of shares at a stated price. They stood to realize a substantial personal profit upon a rise in the price of a stock, and for this, "it was essential that there be an increased demand for the stock" (15 F. Supp. at 316). To stimulate the necessary demand, these defendants hired others to recommend the stock

to their acquaintances and the public generally. The recommendations were made without disclosure of these financial interests. In upholding the Commission's allegations of fraud, the court stated (15 F. Supp. at 317):

> * * * When a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived. United States v. Brown, 79 F. (2d) 321 (C.C.A. 2). * * * In both cases there is an "omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

The Court so held notwithstanding its assumption that the stock was recommended "on its merits" (*id.* at 316, 317).

The Court of Appeals for the District of Columbia Circuit reached the same conclusion in *Hughes* v. *Securities and Exchange Commission*, 174 F. 2d 969. It held that an investment adviser is in a fiduciary relationship with his clients and commits a fraud or deceit by failing to reveal that he simultaneously exercises the role of dealer, thus standing to benefit from their response to his advice.[9] The fact that

[9] The court interpreted the antifraud provisions of the statute to require full disclosure of all relevant data which may be necessary for an intelligent response to securities advice. It stated (174 F. 2d at 976):

"* * * It is not enough that one who acts as an admitted fiduciary proclaim that he or she stands ever ready to divulge

the clients fully understood this dual relationship and that they had been afforded "a high degree of investment protection, financial gain and security and financial peace of mind, * * *" (*id.* at 974), provided no defense.

There is, if anything, an even clearer fiduciary duty here. The defendants in *Torr* were found to have violated the anti-fraud provisions of the securities laws by giving honest investment advice free of charge without revealing their financial interest in the response to that advice. Here, 5,000 subscribers to respondents' "Capital Gains Report" purchased purportedly disinterested advice at a cost of $18 per year. The resulting fiduciary relationship entitles these clients to respondents' unbiased judgment as to the merits of particular securities. Just as in *Torr,* where the court accepted the defendants' insistence that they "recommended the stock solely on its merits" (15 F. Supp. at 317), the respondents in the present case did not fulfill their fiduciary duty merely by giving "honest advice." Their advice had to be "disinterested" as well, and it was not disinterested when they were relying upon its "predictable market effect" as a basis for personal profit (App. A, *infra,* p. 21a). Their failure to satisfy their fiduciary duty to their clients by disclosing all of these facts constituted a "device, scheme, or artifice to defraud," and a "practice, or course of business which operates as a

material facts to the ones whose interests she is being paid to protect. Some knowledge is prerequisite to intelligent questioning. This is particularly true in the securities field. Readiness and willingness to disclose are not equivalent to disclosure."

fraud or deceit" upon their clients within the meaning of Section 206 (1) and (2).

The majority's decision is inconsistent with the majority's own recognition that "federal securities laws are to be construed broadly to effectuate their remedial purpose" (App. A, *infra*, p. 21a; *Securities and Exchange Commission* v. *Joiner Corp.*, 320 U.S. 344, 353–354)—a principle which many other courts have also recognized in construing comparable anti-fraud provisions of the Securities Act of 1933 (Section 17a, 15 U.S.C. 77q(a)), the Securities Exchange Act of 1934 (Section 10(b), 15 U.S.C. 78j(b)) and of Rule 10b-5(3) issued pursuant to the Securities Exchange Act.[10] See *Charles Hughes & Co.* v. *Securities and Exchange Commission*, 139 F. 2d 434 (C.A. 2), certiorari denied, 321 U.S. 786; *Archer* v. *Securities and Exchange Commission*, 133 F. 2d 795 (C.A. 8), certiorari denied, 319 U.S. 767. See also *Speed* v. *Transamerica Corporation*, 235 F. 2d 369, 373 (C.A. 3).

Apparently, this lowering of standards results from a misreading of this Court's decision in *Blau* v. *Leh-*

[10] Like Section 206(1) of the Investment Advisers Act, Section 17(a)(1) of the Securities Act and Rule 10b-5(1) under the Securities Exchange Act utilize the language "to employ any device, scheme, or artifice to defraud." Like Section 206(2) of the Investment Advisers Act, Section 17(a)(3) of the Securities Act contains the language "to engage in any transaction, practice, or course of business which operates [or would operate] as a fraud or deceit." Identical language is contained in Rule 10b-5(3) under the Securities Exchange Act except that the word "act" is substituted for the word "transaction." This language of Rule 10b-5(3) is also contained in Rule 15c1-2(a) under Section 15(c)(1) of the Securities Exchange Act.

man, 368 U.S. 403 (involving the Securities Exchange Act of 1934). The court below relied heavily upon that opinion as presaging a more restrictive interpretation of the securities laws (App. A, *infra,* p. 22a). Only this Court can correct the result.

2. The court below erroneously relied upon the legislative history of the 1960 amendments to the Investment Advisers Act[11] as support for its narrow construction of Section 206 (App. A, *infra,* pp. 22a–27a). This history consists of statements and memoranda of Commission representatives submitted in support of the amendments as well as various congressional committee reports which draw conclusions from these materials. As the dissent below points out, these sources do not support a "narrow interpretation of § 206"; moreover, the majority's "extensive discussion is not of history, but of subsequent statements by the SEC and Congress twenty years after the passage of the Investment Advisers Act" and "reliance on them violates canons of construction laid down by the Supreme Court" (App. A, *infra,* pp. 34a, 35a). See *Rainwater* v. *United States,* 356 U.S. 590, 593.

More specifically, neither these 1959–1960 legislative materials nor the doubts expressed by the Commission concerning the reach of the statute and the need for rulemaking powers were addressed to the

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[11] *Independent Regulatory Commissions,* Report of the Special Subcommittee on Legislative Oversight of the Senate Committee on Interstate and Foreign Commerce, H. Rep. No. 2711, 85th Cong., 2d Sess.; Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 1178, etc., 86th Cong., 1st Sess.; H. Rep. 2179, 86th Cong., 2d Sess.; S. Rep. No. 1760, 86th Cong., 2d Sess.

issue presented here—the legality of "scalping." Commission representatives testified before the House Subcommittee on Legislative Oversight of the Committee on Interstate and Foreign Commerce that the Act did not require an investment advisory service which recommended Crowell-Collier securities to disclose under the circumstances there present that a mutual fund of which it was adviser held stock in that concern. They pointed out, however, that in many cases failure to disclose an interest in a security might involve a fraud upon a client within the meaning of Section 206 of the Act.[12]

The Commission has never taken the position that the antifraud provisions do not reach the scalping practices here involved, which go far beyond the recommendation of a security in which the adviser has an interest, since here the adviser made a practice of reaping a personal profit from trading in the securities which he recommended. The views expressed by the Commission in connection with the 1960 legislation concerned the need for rule-making powers to proscribe non-fraudulent practices which, in the Commission's judgment, lead to fraud. Since scalping meets the standard of fraud which the courts have applied in construing federal securities laws, its illegality is unaffected by these views.

That the Commission has always so believed is borne out by its enforcement action. In 1946, the Commission acted under Section 206(2) in proceeding against scalping practices indistinguishable from

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[12] *Investigation of Regulatory Commissions and Agencies*, 85th Cong., 2d Sess., Part 12 (Hearings of September 17, 1958), pp. 4838–4840.

those permitted by the court below. See *Securities and Exchange Commission* v. *Frank Payson Todd*, Civil No. 6149 (D. Mass.).[18] Cf. *Seipel* v. *Securities and Exchange Commission*, 229 F. 2d 758 (C.A.D.C.).

3. The 1960 amendment to Section 206 of the Investment Advisers Act, on which the majority below relied (App. A, *infra*, pp. 22a–23a), neither supports the decision nor militates against the need for review by this Court. As Judge Clark pointed out for the dissenters, the holding of the majority is "based on a seriously limiting interpretation of the antifraud provisions of the Act" (App. A, *infra*, p. 32a), and if allowed to stand, is likely to have serious re-

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[18] In that case, the defendant admitted the allegations of the complaint and consented to the entry of an injunction. Securities and Exchange Commission Litigation Release No. 372, November 14, 1946, describes the defendant's activities as follows:

"The complaint alleged that Todd defrauded investment advisory clients in the following manner: Todd issues a weekly letter, 'The New England Counsellor,' in which he advises subscribers with respect to the purchase of securities. He also has certain clients who for an additional fee obtain more personalized advice, and until recently he managed a number of discretionary accounts. Todd would withhold making his recommendation to purchase specific securities for several days, during which he would purchase the security for his discretionary accounts and orally recommend its purchase to clients receiving more personalized advice. It would usually be an inactive security and, when the market had been raised by the subscribers' purchases, Todd would sell the security in his discretionary accounts, meanwhile continuing to recommend its purchase in his weekly letter."

The Commission's complaint alleged that Todd "managed a discretionary account in the name of his wife, Mary K. Todd."

The injunction was later vacated on grounds not germane here. 3 Loss, *Securities Regulation* (2d ed. 1961) 1516.

percussions upon the protection of investors which the Act was designed to provide.[14]

The 1960 amendments (74 Stat. 885, 887) added Subsection (4) to Section 206 of the Investment Advisers Act, which provides:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> * * * * *
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

In determining the need for review in this case, it is immaterial whether or not the amendment permits the Commission to proscribe conduct which is neither

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[14] See Educational Circular No. 170 of the New York Stock Exchange, November 16, 1962, p. 4, discussed in the Wall Street Journal, November 19, 1962, p. 4, cols. 2, 3, as follows:

"In its circular the [Stock Exchange] warned member-firm personnel to refrain from trading in any security shortly before or after a recommendation to buy or sell that security had been issued by the firm. They are prohibited from buying and selling such recommended securities either for accounts in which they have an interest or accounts in which they have authority to use their own judgment in trading. They are also prohibited from 'passing on advance information concerning the report to persons outside their firm.'"

"fraudulent" nor "deceptive."[18] The language of Subsection (4) is not self-executing. The Commission has for many years interpreted comparable provisions of the Securities Exchange Act, Section 15(c)(2), 15 U.S.C. 78*o*(c)(2), as granting only rulemaking power and not themselves imposing any substantive requirements. It views Section 206(4) of the Investment Advisers Act as similarly requiring it to issue implementing rules and regulations before proceeding under that subsection.

Nor is the need for review vitiated by the majority's suggestion that its limiting interpretation of the antifraud provisions is of little consequence because the Commission now has authority to prohibit this conduct by rules and regulations. Concededly, Subsection (4) authorizes, and the Commission could draft, a rule which would proscribe, as a "means reasonably designed to prevent" fraud, the specific conduct described in the complaint initiating this action. However, the necessity of proceeding by rule would be a pale substitute for the "general and

[18] There may be a question of the extent to which "manipulative" reaches activities which are not also "fraudulent" or "deceptive." See, for example, Section 15(c)(1) of the Securities Exchange Act which directs the Commission to adopt rules defining "such devices or contrivances as are manipulative, deceptive, or *otherwise* fraudulent" (emphasis supplied). And cf. *United States* v. *Brown*, 79 F. 2d 321, 325 (C.A. 2), where in a case under the mail fraud statute, 18 U.S.C. 338, Judge Learned Hand explained: "Wash sales [a common form of manipulation] are a deceit, because they broadcast the fact that a buyer and a seller have agreed to exchange the shares at the published price, when they have not done so." Manipulation involves activities conducted for the purpose of artificially influencing the market.

flexible" antifraud provisions which the courts have long recognized as necessary to keep in check "the versatile inventions of fraud-doers."[16] If the Commission is to prevent clever operators from keeping one step ahead of the enforcement officers, it should not be limited to proceeding by rules which attempt to catalogue in advance every species of fraud. The decision below, in suggesting that the Commission's authority is so limited, seriously impedes future enforcement of the securities laws.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted.

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NOVEMBER 1962.

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[16] *Stonemets* v. *Head*, 248 Mo. 243, 154 S.W. 108, 114; and see *Archer* v. *Securities and Exchange Commission*, 133 F. 2d 795, 803 (C.A. 8), certiorari denied, 319 U.S. 767. And see *State* v. *Whiteaker*, 118 Ore. 656, 247 Pac. 1077, 1079.

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 30—September Term, 1961

(Argued October 13, 1961, Decided December 18, 1961)

Docket No. 26942

SECURITIES AND EXCHANGE COMMISSION,
Appellant,

v.

CAPITAL GAINS RESEARCH BUREAU, INC.,
AND HARRY P. SCHWARZMANN,
Appellees.

Before:

CLARK, WATERMAN and MOORE,
Circuit Judges.

MOORE, *Circuit Judge:*

Plaintiff (appellant), Securities and Exchange Commission (SEC), in its complaint, alleging violations of Section 206 (1) and (2) of the Investment Advisers Act of 1940, 15 U.S.C.A. 80b–6 (1) and (2), sought a temporary restraining order, preliminary injunction and final injunction against defendants (appellees), Capital Gains Research Bureau, Inc. and Harry P. Schwarzmann, to prevent them from employing "any device, scheme or artifice to defraud any client or prospective client" and from engaging

"in any transaction, practice and course of business which operates as a fraud or deceit upon any client or prospective client." By order to show cause based upon the complaint and an affidavit of an SEC investigator, a temporary restraining order was granted and a hearing upon an application for a preliminary injunction was directed. No additional proof was offered by the SEC upon the hearing; Schwarzmann, as owner of Capital Gains and as a defendant, submitted an affidavit opposing the application. The District Court upon this proof denied the motion for a preliminary injunction and vacated the stay. The SEC appeals.

Injunctive relief before a trial on the merits should be granted most sparingly and only upon convincing proof that irreparable injury will be caused unless the courts stay the defendants' conduct. Furthermore, the courts generally will not grant a preliminary injunction when the effect thereof will be to give the applicant all the relief to which he would be entitled if successful upon the final injunction trial.[1]

Applying these principles to the facts, the conclusions are inescapable that the SEC did not meet the "convincing" proof standard and that a preliminary injunction for all practical purposes would have given to the SEC all that it could have received by final injunction after trial.

Section 206 declares that it is unlawful for any investment adviser (1) "to employ any device, scheme or

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[1] *W. A. Mack, Inc.* v. *General Motors Corp.* (7th Cir. 1958), 260 F. 2d 886; *Foundry Services* v. *Beneflux Corp.* (2d Cir. 1953), 206 F. 2d 214, 216; *Selchow & Richter Co.* v. *Western Printing & Lithographing Co.* (7th Cir. 1940), 112 F. 2d 430, 431; *United States* v. *Adler's Creamery* (2d Cir. 1939), 107 F. 2d 987, cert. denied, 311 U.S. 657 (1940); *Gross* v. *Kennedy*, 183 F. Supp. 750, 757 (S.D.N.Y. 1960); *Carey* v. *General Electric Co.*, 165 F. Supp. 127 (S.D.N.Y. 1958); *Dressler* v. *Wilson*, 155 F. Supp. 373, 376 (D.D.C. 1957).

artifice to defraud any client or prospective client" or (2) "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Fraud is the keynote of these provisions and the burden placed upon the party alleging fraud is that it be established by "clear and convincing"[2] proof.

The only question presented upon appeal at this stage of the proceedings (namely, in advance of a trial upon the merits) is whether the facts were so clear and convincing that fraud and deceit were being practiced upon defendants' clients that the District Court abused its discretion in not granting a preliminary injunction and in preferring to await the development of all the facts upon a trial before decreeing drastic injunctive sanctions.

Capital Gains publishes an investment advisory service. It distributes two bulletins, one entitled "Facts on the Funds" (not involved in this proceeding), which informs subscribers as to changes in the portfolios of Mutual Funds and another headed "Special Recommendation" or "Special Bulletin" which gives financial facts and figures concerning the specific company made the subject of the analysis. Only certain bulletins involving the special situations are before the court.

The SEC did not present in support of its application for a preliminary injunction any of the reports upon which it relied as showing a failure to disclose material facts. However, this deficiency was remedied by defendants who attached the special bulletins to their answering affidavit. In substance, the bulletins

[2] *United States* v. *Thompson* (10th Cir. 1960), 279 F. 2d 165, 167, wherein the court referred to "the spirit of the long accepted rule of law that one who asserts fraud has the burden of proving it by clear and convincing evidence." See also 9 Wigmore, Evidence § 2498 (3d ed. 1940).

contain figures showing the corporate earnings over a period of years of the companies therein analyzed, an outline of the nature and current status of the business, future prospects, earnings and price-to-earnings ratios, (in some cases) the number of Funds which own the stock, and usually a brief résumé of assets and profits.

All seven companies[3] analyzed are substantial companies in their respective fields and their stocks have been listed and traded on the New York Stock Exchange for many years. No charge is made by the SEC that any misstatements or false figures were contained in any of the bulletins; that the investment advice was unsound; that defendants were being bribed or paid to tout a stock contrary to their own beliefs; or that these bulletins were a scheme to get rid of worthless stock. The SEC premises its entire case upon the fact that shortly before the bulletins were mailed, defendants, consistent with their forthcoming recommendations, purchased shares of the stock and, in one instance where they suggested that the stock was too high, sold short. The SEC then points to the facts that there were small market rises in each of the stocks following publication and that defendants sold the stocks previously purchased (or covered as to the short sale) by them within a week or two thereafter. Thus, the SEC by its own fiat would create a law not enacted by Congress or a regulation not promulgated by the SEC to the effect that the failure to disclose to clients to whom purchase was recommended that they (defendants), too, had made purchases, constituted a scheme to defraud by failing to disclose a material fact. But what is

[3] Continental Insurance, Creole Petroleum, Union Pacific, Hart, Schaffner & Marx, United Fruit, Shattuck and Chock Full O'Nuts.

the "material fact"? The SEC does not and cannot argue that it consists of a belief that the stock was a "sell" instead of a "buy" because there is no proof of any such belief. Furthermore, the action of defendants was consistent with their recommendations and belies such an inference. Of the seven stocks involved, the purchases (or in one case the short sale) in most instances were made just three to seven days before the reports containing the recommendations were mailed to the clients. Thus it would appear that the purchases were the result of the forthcoming recommendations. Certainly without any supporting proof a conclusion would not be justified that the recommendations were made to enable defendants to unload their own recently acquired and comparatively small holdings.

Presumably the SEC relies upon the defendants' subsequent sales as implying a belief that the stock analyzed was not a good purchase to be held more than six months. But even a then present intention to sell shortly after publication will not support an inference that the recommendation to others to buy and hold for the capital gains period was fraudulent or deceptive. And if this be the material omission, what is the remedy? A mere statement in the bulletins that defendants also owned certain shares would accomplish nothing. Thousands of other persons owned shares of the same companies. A statement that defendants intended to sell within two weeks would not be accurate because their intention to buy, sell or hold could be determined only in the light of then unknown events. If the market were strong, they might wish to take a small profit on an "income" tax basis or hold for the six months capital gains period; if the market were weak they might wish to limit their losses by selling or holding for a longer period, hoping for a recovery. Surely, no one could

be so naive as to believe that a small advisory service with only 5,000 subscribers could by its own recommending influence cause such stocks as Union Pacific (22,000,000 shares outstanding), Continental Insurance (12,000,000 shares outstanding) and United Fruit (8,730,000 shares outstanding)[4] invariably and automatically to rise so that defendants could always sell their small holdings at a small profit. In the one instance, Hart, Schaffner & Marx, where the company had less than one million shares outstanding, the clients were told that purchases were recommended "around the $23-$24 level" (the then current price). Such advice would hardly be consistent with an inference that it was intended thereby to raise the market price by their own clients' buying power. Moreover, it is significant that the SEC introduced no proof that any client ever purchased any shares of the recommended securities. The SEC's conclusion that these particular 5,000 subscribers must have rushed in, thereby creating an artificial stimulant, is wholly speculative and is at variance with common sense. Consider realistically the buying power which comes from pension funds, investment trusts, university and hospital endowments, foundations, insurance companies and some 180,000,000 citizens with their millions available daily for investment. In the light of such a situation, the comparatively few shares out of 22,000,000 (Union Pacific) that Schwarzmann's clients might have ordered would have been as the proverbial grain of sand is to the beach. And flattering though it might be to Schwarzmann, would anyone believe that his recommendation would stem the tide of decline if some pessimistic world event were simultaneously announced, some Mutual Fund chose to sell or an estate had to be liquidated?

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[4] Approximate figures.

The SEC contends that present intent to sell a stock in the near future if it rises must be accepted as conclusive proof that the advice to buy was dishonest and fraudulent. However, do not the vast majority of those who buy hope to sell at some time at a profit? When the sale will take place can be determined only by considerations personal to each purchaser. His own financial needs, his trading policy, his habit of accepting small profits or his policy of buying for the so-called long pull will control his actions. Of necessity, every purchase and sale transaction involves diametrically opposed thoughts by two individuals concerning the same stock but this does not create fraud and deception so long as false facts and figures have not motivated their action.

The result reached by the District Court in no way weakens the praiseworthy role of the SEC in its vigilant protection of unwary investors. The SEC correctly argues that federal securities laws are to be construed broadly to effectuate their remedial purpose. Nor can there be any serious dispute that a relationship of trust and confidence should exist between the adviser and the advised. A good example of a violation of this principle is found in *SEC* v. *Torr*:[5]

> When a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived.

Another illustrative situation is in *Ridgely* v. *Keene*, 134 App. Div. 647, 119 N.Y.S. 451 (1909), where an

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[5] 15 F. Supp. 315, 317 (S.D.N.Y. 1936), rev'd on other grounds (2d Cir. 1937), 87 F. 2d 446.

investment adviser failed to disclose that he was being paid to tout a stock.

The SEC's exception to the District Court's comment that there is no proof that any client lost any money by reason of defendants' acts is also well taken. The test is not gain or loss. It is whether the recommendation was honest when made.

The many cases cited by appellant and appellees are not germane to a resolution of the problem here presented. For the most part, they deal with the purchase and sale of securities by or through brokers where inside or so-called confidential information was possessed by one party to the transaction which was not disclosed to the other. These situations are typified by the recent decision of the SEC in *"In the Matter of Cady, Roberts & Co.*—No. 8-3925" (Nov. 8, 1961) wherein a broker having received advance notice of a substantial reduction in a company's dividend sold large quantities of the stock to purchasers who had no knowledge of the dividend cut and who undoubtedly would not have purchased (at least at the then quoted price) had they known the facts.

Nor is the decision of the District Court in any way at variance with the salutary purpose of the Investment Company Act of 1940 or the Investment Advisers Act of 1940. This court said in *Charles Hughes & Co.* v. *SEC* (2 Cir. 1943), 139 F. 2d 434, "The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do * * * " (Clark, C.J.). And so it is. However, each case must be judged upon its particular facts after a full and fair hearing and not upon unwarranted inferences.[*]

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[*] See *Hughes* v. *Treat*, 22 S.E.C. 623 (1946), where the proceedings were dismissed on the facts; Litigation Release 372 on *SEC* v. *Todd*, cited in 3 Loss, Securities Regulation, 1516, n. 122 (2d ed. 1961), where although the defendant had orig-

In final analysis what the SEC would have the court do here is to create a law which Congress has never enacted or a regulation which the SEC has never promulgated which, in effect, would prohibit investment advisers or their employees from purchasing or selling any of the many stocks covered by their services. Any such drastic legislation or regulation should be enacted only after hearings upon which the need, if any, for any such remedial legislation can be explored and all interested parties given an opportunity to be heard. Any such regulation should come only as suggested by the Supreme Court in *Miner* v. *Atlass*, 363 U.S. 641, 650 (1960) with respect to procedural innovations "only after mature consideration of informed opinion from all relevant quarters, with all the opportunities for comprehensive and integrated treatment which such consideration affords."

The benefits to be derived by the investing public, which otherwise would have no adequate basis for forming an opinion, as a result of receiving advice honestly given based upon the analysis of financial experts, scarcely can be doubted. A senior financial statesman, Bernard Baruch, has said:

> What of the man or woman with modest savings who is simply looking for a fair return on his or her savings and who cannot give full time to a study of investments? My advice to such persons is to seek out some trusted investment counselor.[7]

Congress and the SEC have been watchful of the interests of the investor. In September, 1960, Sec-

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inally consented to an injunction, it was vacated without objection by the SEC in order to permit a trial on the merits and eventually the SEC agreed to a dismissal because the provable facts would not have supported an injunction.

[7] BARUCH, MY OWN STORY (1957).

666841—62——3

tion 80b–6 was amended and subparagraph (4) was added (74 Stat. 887, P.L. 86–750 § 9) giving to the SEC the power to "by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." As stated in Senate Report No. 1760, June 28, 1960 (the Senate bill was passed). "This provision would enable the Commission to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his clients." Acting thereunder the SEC in August, 1961, published its revised proposal to adopt its first Rule (Rule 206(4)–1) which declared certain advertisements by investment advisers to be fraudulent, deceptive or manipulative within the meaning of Section 206(4) of the Act. The SEC invited comments and suggestions on the proposals and after careful consideration thereof adopted a Rule, effective January 1, 1962. The stated and obvious purpose of the future date was to give persons and companies affected thereby an adequate opportunity to know the prohibition before they were condemned for violating it. (See, SEC Release No. 121, Nov. 2, 1961.) The same charge of fraud and deception might have been made against previous advertisements because it is common knowledge that for decades the public press has carried advertisements of investment advisory or stock trading services that listed their profitable selections and minimized or omitted their less successful recommendations. Believing that such advertising is deceptive and misleading, the SEC directs its discontinuance. But believing equally in fair play, the SEC affords a reasonable opportunity for compliance rather than seeking an immediate injunction against the advertising now in effect.

It is most significant that there is no statute, rule or regulation against any investment advisory service owning any shares of any security recommended or against the purchase or sale of any such shares within a specific period of time before or after publication. Whether such a rule would be in the public interest is not for judicial legislation or adjudication. The SEC has been charged by Congress with the making of such rules. The SEC has evinced a wise policy of promulgating its rules only after a careful study of all the facts, the holding of hearings, the weighing of testimony from interested parties, and consideration of comments and suggestions. Hundreds of individuals and companies are engaged in the business of investment advisers. What is the impact, if any, on the market of the investment advice of any one bulletin? Of what influence, if any, is the number of subscribers (1,000 or 50,000)? What if one service recommends the sale of a certain stock simultaneously with the independent recommendation of another service to purchase the same stock?[8] Is fraud to be presumed; and, if so, by which service? Countless other questions suggest themselves with which, if there be any need for regulation or control, the SEC will have to cope. For the present and until the facts are fully developed, it seems appropriate that the courts in piecemeal fashion do not try to take over the regulatory function of the SEC and single out a rather small advisory service and hold it in advance of trial responsible for violation of a rule which has not yet been promulgated and as to which there is no certainty that it ever will be.

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[8] The daily press and financial journals in reporting upon changes in Mutual Funds portfolios frequently disclose that the business judgment of one Fund dictated the sale of a certain stock at approximately the same time that another Fund considers the same stock an advisable purchase.

The order denying a preliminary injunction is affirmed.

CLARK, *Circuit Judge* (dissenting).

It can be demonstrated, I believe, that my brothers here have given a uniquely restrictive interpretation to the Investment Advisers Act of 1940—the last of the six great regulatory statutes governing dealings in investments—contrary to the general judicial approach to these statutes. But before I discuss this troublesome ruling I think I should note the unfortunately wide scope of the decision and its public importance. For it endorses and in effect validates a distressingly low standard of business morality. Cutting through all the procedural steps and noting the denial of the very mild and nonpunitive remedy of an injunction only preventing future violations, I find it all too clear that the opinion here, re-emphasizing the opinion below, has found nothing objectionable, much less illegal, in an investment adviser—a business fiduciary according to the intent of the regulatory statute—making substantial profits by secretly playing the market contrary to his advice to customers. I suspect the license thus granted is one the top advisers—those who are trusted by the banks, the insurance companies, and the investors generally—not only do not desire, but find rather shocking, in the doubt thus cast upon the good faith and loyalty of all of their profession. For all are thus reduced, in the eyes of the law, to the standards of the lowest.

While the over-all trend of the decision is thus obvious, the opinion does not make the facts or the law sufficiently clear to clarify the central legal issue. Actually the facts are substantially not in dispute; and the issue is whether the prohibitions of the Act, particularly those which prohibit engaging in any

course of business "which operates as a fraud or deceit upon any client or prospective client," 15 U.S.C. § 80b–6(2), are limited strictly to common law fraud, as the district court held, or express a wider fiduciary obligation of full disclosure of conflicting ties and full loyalty to the client's interest. As to the facts the S.E.C.—with commendable expedition and zeal, considering all the ramifications of its far-ranging tasks and the difficulties of detection generally—uncovered a half-dozen cases of private stock dealings by defendant Capital Gains at the behest of its sole stockholder and owner, Schwarzmann. These the Commission quite properly accepted as a pattern of defendants' normal activities, sufficient upon which to base a prayer for a preventive remedy for the future. The pattern was that Capital Gains would privately buy some well known stock for its private account, that it would describe the stock favorably in its bulletin "Special Recommendation" or "Special Bulletin," distributed to its 5,000 subscribers and frequently quite widely to the public on a mailing list of about 100,000, and that then in a few days, perhaps a couple of weeks or less, when the market price of the stock had risen, it would sell out, pocketing the gain. Apparently it did not look for spectacular market swings, but nevertheless it was able to achieve fairly steady profits from this course of dealings. In one spectacular case it combined this scheme successfully with the short selling of a stock it then proceeded to decry in its report as overpriced.

Defendants did not deny these specific instances, but attempted to play them down, stressing particularly that their operations were too small to cause the market swings and that their clients did not lose because the stocks were good investments. Of course it is difficult to tell surely what will cause a good stock to go up a few points; but it seems likely that con-

centrated buying may have some effect, and it is significant that in each case the market did actually respond in the way desired. But this defense, which has been fully accepted by my brothers, completely misses the point. A first duty of a fiduciary is loyalty to his beneficiary; if he is engaged in feathering his own nest, he cannot be giving his client that wholly disinterested advice which it is his stock in trade to provide. My brothers appear to assume that the practices indulged in by the defendants here are quite widespread on the part of investment advisers. There is not a bit of evidence before us to this effect, and personally I do not believe it for a minute. But further it appears quite clear that it was the purpose of the legislation to outlaw and stop such practices.

The history of this legislation shows a Congressional intent to establish a fiduciary relationship on the part of the adviser to his client; it also shows a purpose to safeguard bona fide investment counsel against the stigma of the activities of unscrupulous tipsters and touts. This is convincingly traced by the leading academic authority in the field, 2 Loss, Securities Regulation 1392 *et seq.* (2d Ed. 1961). It is quite obvious that this broad and complete supervision of the adviser who was required by the Act to register would be quite frustrated if the Commission had to show at every step common law fraud, including intentional misrepresentation to a specific person to his individual loss. Actually there is convincing evidence to the contrary. As Professor Loss, after quoting the two subsections relied on by the Commission, § 206 (1) and (2); 15 U.S.C. § 80b–6 (1) and (2), points out: "These clauses are modeled on Clauses (1) and (3) of § 17(a) of the Securities Act [15 U.S.C. § 77q(a) (1) and (3)]. Consequently, everything which has been said thus far in this chapter applies with equal force to investment advisers *mutatis mutandis*." 3

Loss, Securities Regulation 1515 (2d Ed. 1961). This carries his discussion back to his earlier detailed consideration of SEC "fraud" concepts going well beyond circumstances giving rise to a common law action of deceit. 3 Loss, Securities Regulation 1430, 1435, 1474 (2d Ed. 1961), with citation of cases such as *Charles Hughes & Co.* v. *S.E.C.*, 2 Cir., 139 F. 2d 434, 437, certiorari denied 321 U.S. 786; *Hughes* v. *S.E.C.*, D.C. Cir., 174 F. 2d 969; *Norris & Hirshberg, Inc.* v. *S.E.C.*, D.C. Cir., 177 F. 2d 228, and other cases cited in 3 Loss, *id.* 1435 n. 19. A fiduciary who recommends the purchase of a particular stock because or after he has secretly taken a position in that stock which will make his recommendation profitable for him is guilty of deception if he conceals the secret motive underlying his advice. Indeed, this appears to be the law even without statute. *Ridgely* v. *Keene*, 1909, 134 App. Div. 647, 119 N.Y.S. 451, 453.

In 1960, upon recommendation of the SEC and with the announced purpose of tightening up the Act, a series of amendments were passed. 2 Loss, *id.* 1395; 3 Loss, *id.* 1515–1518. There was then added to this statute by amendment of Sept. 6, 1960, 74 Stat. 887, a fourth paragraph, 15 U.S.C. § 80b–6(4), which is important enough here to quote: "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

Since most of the events here involved took place before the statute became effective, the SEC has not relied on it to sustain the requested injunction, though it would seem that the first sentence could be cited to support the prospective remedy here sought which

operates only in the future. It should be particularly noted that the provision adds powers and terms of regulation; it nowhere cuts down or reduces them.

Curiously enough my brothers seize upon this statute to cut down the clear grant of authority expressed in words already defined in the earlier statutes. While seemingly agreeing that the new statute gives the Commission the authority to proceed against practices of the general type here involved, they state that this authority cannot be exercised until a specific rule outlawing this precise behavior has been promulgated. But the statute is eloquently silent as to any such condition, and is in terms broadly prohibitive. And the argument misconceives the significance of the grant of rule-making power. It is Congress which declares the policy and defines the prohibitions, while the SEC is authorized to adopt regulations not to vary, but to aid in the execution of, the policy. Cf. *S.E.C.* v. *Chenery Corp.*, 332 U.S. 194. Here the SEC, with commendable expedition, having in mind the necessity of extensive hearings and full consideration of the various interests needing to be heard, has substantially completed work upon at least preliminary regulations under this statute. It is to be noted that those already published seem shrewdly framed in terms of ways and means for the better effectuation of the policy, rather than its variation.[1] In my judgment, therefore, the new statute has been put to a wholly improper argumentative use; it supports rather than undercuts the Commission's position.

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[1] The opinion cites SEC Release No. 121, Nov. 2, 1961, dealing with fraudulent, deceptive, or manipulative advertising by investment advisers. It should have cited SEC Release No. 120, Oct. 16, 1961, requiring registration of stock dealings by advisers *and their staffs*. These proposed regulations are obviously means and devices to effectuate the declared policy of the statute, not to make different policy.

My brothers find various procedural objections to an injunction *pendente lite* here, citing a variety of legal clichés which have certain fields of operation, but which are quite inapposite here. Thus the injunction was not refused by the district judge as a matter of discretion weighing the equities; it was refused on the basis of an erroneous ruling of law, and a claim of right thereto by the defendants. Of course we must and do correct such mistakes as a matter of course on appeal from a denial of injunctive relief, see, e.g., *Ring* v. *Spina,* 2 Cir., 148 F. 2d 647, 160 A.L.R. 371. Then there is the statement that a preliminary injunction should not grant what is being sought permanently. This means only that a case should not be prejudged prior to a full hearing beyond what is necessary fairly to preserve the parties' right. Of course it cannot mean—and this is belied in daily practice—that an injunction cannot issue when the plaintiff's right to ultimate relief is shown; that would be to say in effect that the better the plaintiff's case, the less chance he has for any remedy until a possibly protracted trial is completed. Here there is a strong public interest involved, both on the part of the investing public and on the part of other investment advisers whose reputation is being sadly traduced by the defendants' activities. On the other hand, the defendants are little prejudiced by the nonpunitive injunction sought, which merely directs them in the future to follow that course of conduct which they ought to wish to do anyhow, particularly if they would retain any shred of reputation as a trustworthy adviser. Further it will relieve this important commercial court of the stigma of supporting low business practices. The decision below should be reversed for the grant of an injunction *pendente lite.*

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 30—September Term, 1961

(Rehearing en banc February 22, 1962
Decided July 13, 1962)

Docket No. 26942

SECURITIES AND EXCHANGE COMMISSION,
Appellant,

against

CAPITAL GAINS RESEARCH BUREAU, INC., and
HARRY F. SCHWARZMANN,
Appellees.

Before:

LUMBARD, *Chief Judge,* and
CLARK, WATERMAN, MOORE, FRIENDLY, SMITH,
KAUFMAN, HAYS and MARSHALL, *Circuit Judges.*

MOORE, *Circuit Judge*:

Plaintiff, (appellant), Securities and Exchange Commission (SEC), in its complaint, alleging violation of Section 206 (1) and (2) of the Investment Advisers Act of 1940, 15 U.S.C.A. 80b–6 (1) and (2), sought a temporary restraining order, preliminary injunction and final injunction against defendants

(appellees), Capital Gains Research Bureau, Inc., and Harry P. Schwarzmann, to prevent them from employing "any device, scheme or artifice to defraud any client or prospective client" and from engaging "in any transaction, practice and course of business which operates as a fraud or deceit upon any client or prospective client." By order to show cause based upon the complaint and an affidavit of an SEC investigator, a temporary restraining order was granted and a hearing upon an application for a preliminary injunction was directed. No additional proof was offered by the SEC upon the hearing; Schwarzmann, as owner of Capital Gains and as a defendant, submitted an affidavit opposing the application. The District Court upon this proof denied the motion for a preliminary injunction and vacated the stay. 191 F. Supp. 897 (1961). The SEC appealed. A panel of this court affirmed the district court's order. 300 F. 2d 745. A petition of the SEC for a rehearing *en banc* was granted.

The only question presented at this stage of the proceedings, namely, an application for a preliminary injunction in advance of a trial upon the merits, is whether a violation of section 206(1) and (2) has been so clearly established that defendants are, in effect, to be found at fault without awaiting the development of all the facts upon a trial.

The SEC brings this proceeding under subsections (1) and (2) of Section 206. These subsections make it unlawful "(1) to employ any device, scheme, or artifice to defraud any client or prospective client" or "(2) to engage in any business which operates as a fraud or deceit upon any client or prospective client."

Capital Gains publishes an investment advisory service. It distributes two bulletins, one entitled "Facts on the Funds" (not involved in this proceed-

ing), which informs subscribers as to changes in the portfolios of Mutual Funds and another headed "Special Recommendation" or "Special Bulletin" which gives financial facts and figures concerning the specific company made the subject of the analysis. Only certain bulletins involving the special situations are before the court.

The SEC did not present in support of its application for a preliminary injunction any of the reports upon which it relied as showing a failure to disclose material facts. However, this deficiency was remedied by defendants who attached the special bulletins to their answering affidavit. In substance, the bulletins contain figures showing the corporate earnings over a period of years of the companies therein analyzed, an outline of the nature and current status of the business, future prospects, earnings and price-to earnings ratios, (in some cases) the number of Funds which own the stock, and usually a brief resume of assets and profits.

All seven companies[1] analyzed are substantial companies in their respective fields and their stocks have been listed and traded on the New York Stock Exchange for many years. No charge is made by the SEC that any misstatements or false figures were contained in any of the bulletins; that the investment advice was unsound; that defendants were being bribed or paid to tout a stock contrary to their own beliefs; or that these bulletins were a scheme to get rid of worthless stock. The SEC premises its entire case upon the fact that shortly before the bulletins were mailed, defendants purchased shares of the stock and, in one instance where they suggested that the

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stock was too high, sold short. The SEC then points to the facts that there were small market rises in each of the stocks following publication and that defendants sold the stocks previously purchased (or covered as to the short sale) by them within a week or two thereafter.

The SEC correctly argues that federal securities laws are to be construed broadly to effectuate their remedial purpose. Nor can there be any serious dispute that a relationship of trust and confidence should exist between the advisor and the advised. A good example of a violation of this principle is found in *SEC* v. *Torr*:[9]

> When a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived.

Or if it were established that Capital Gains made its recommendations for the purpose of endeavoring artificially to raise the market so that it might unload its holdings at a profit, such conduct might well find itself within the prohibitions of Section 206 (1) and (2).

But here the SEC's proof tends only to show that, at most, defendant Schwarzmann profited personally from the predictable market effect of his honest advice. There is no proof that defendants employed "any device, scheme or artifice to defraud any client or prospective client" or engaged "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective

[9] 15 F. Supp. 315, 317 (S.D.N.Y. 1936), rev'd on other grounds (2 Cir. 1937), 87 F. 2d 446.

666841—62——4

client." The SEC's case, both here and in the court below, has been based entirely upon section 206, subsections (1) and (2) of the Act. And in interpreting these sections we must take account of the recent warning of the Supreme Court against excessive judicial expansion of provisions of the securities laws to accomplish objectives believed to be salutary. *Blau* v. *Lehman,* 368 U.S. 403 (1962).

Although there is no direct occasion to consider whether defendants' activities were "manipulative" under the prohibition added to the Act by the Act of September 15, 1960, 74 Stat. 885, 15 U.S.C. § 80b-6 (4), or could be prohibited by an SEC rule under that section, the amendment is not without significance. To section 80b-6 containing subsections (1) and (2) were added (3) (not here relevant) and (4) which made it unlawful for any investment adviser "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."

By the enactment of subparagraph (4), section 80b-6, the SEC now has been directed by Congress "by rules and regulations [to] define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative." The SEC has not shown itself reluctant to consider and draft "rules and regulations" toward this end. Already it has issued regulations dealing with registration of stock dealings by investment advisers and their staffs and with types of advertising deemed to be fradulent or deceptive. (See SEC Releases Nos. 120, 121, October 16, 1961, November 2, 1961.) The extent, if any, to which the SEC may believe it desirable to go in regulating purchases or sales of securities by investment advisory publishers at or about the time of comment in their publications concerning such securities has been entrusted by Congress to the SEC. However, here the SEC's case

is predicated solely on the deliberately meagre provisions of § 206 (1) and (2) as enacted in 1940, 54 Stat. 853, and not on § 206(4) added by the Act of September 15, 1960, 74 Stat. 885. Whether conduct such as defendant's is now forbidden as a "manipulative" practice under the first clause of (4) or only if prohibited by detailed rules and regulations promulgated by the Commission, is an issue neither presented nor determined.

The legislative history of the Investment Advisers Act strongly supports our interpretation of the langauge of subsections (1) and (2). The Investment Advisers Act of 1940 was not as comprehensive as the Securities Act of 1933 or the Securities Exchange Act of 1934. It did not have to deal with the purchase and sale of securities and broker-dealer-customer relationships. Rather the Act was thought to be a modest beginning—not a great and final piece of legislation. "It followed a brief supplemental report on investment advisers which the Commission had filed as an incident of its investment trust study." Loss, "Securities Regulations," Vol. II, pp. 1392–1393. The report did not even propose legislation in any formal way, let alone define its scope. It merely described the investment counselling business in the United States and set forth state legislation on the subject, as well as showing how the Investment Counsellors of America regulated themselves internally. A representative of the SEC, testifying before the Senate committee in 1940, said the SEC knew very little about the investment-advising business and, therefore, the "fundamental approach" of the proposed legislation was to get a "compulsory census" of the industry. "Aside from that fundamental approach the only other provisions in that title are just a few broad generalizations which say that you cannot embezzle your client's

funds or you cannot be guilty of fraud." Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 3580, pt. 1, 76th Cong., 2d Sess. (1940), p. 48. Hence, as Loss also tells us, "For twenty years this statute was little more than a continuing census of the Nation's investment advisers" until it "was substantially tightened up by a series of amendments in 1960, fifteen years after the Commission had first urged such action in a special report to Congress."

The history of the 1960 amendment confirms the narrow scope of the initial enactment, in an area highly relevant here. This history begins with a report by the Senate Subcommittee on Legislative Oversight in which there was a short section on the Investment Advisers Act. This section says (p. 53 of the report):

> "Our recommendation that the act be amended arises from the fact that as shown in the hearings held September 17, 1958 (transcript, pp. 3753–3767), investment advisers are not now required to disclose the financial interest of affiliates in securities concerning which they give advice."

This conclusion had arisen from hearings on the Crowell-Collier issue of convertible debentures. An affiliate of the issuer was an investment adviser, and had recommended the issue without disclosing its interest. The Subcommittee commented (p. 54):

> "The failure to disclose to Investment Survey subscribers an obvious 'dual interest' with respect to Crowell securities did not constitute a specific violation of the act; see testimony by SEC personnel, transcript pages 3755, 3756."

The Subcommittee called for amendment of the act to make sure that such behavior would be a violation, quoting a statement of SEC Chairman, Edward N.

Gadsby, that it was now time to strengthen the act to make it more than "a mere census taking." See Independent Regulatory Commissions, Report of the Special Subcommittee on Legislative Oversight of the Senate Committee on Interstate and Foreign Commerce, H.R. Rep. No. 2711, 85th Cong., 2d Sess. (1959), pp. 53–54.

The SEC staff prepared a memorandum describing the reasons for the various amendments that were being proposed in 1959. The section relating to the new subsection (4) for § 206, Hearings Before a Subcommittee of the Senate Committee on Banking and Currency on S. 1176, etc., 86th Cong., 1st Sess. (1959), pp. 516–517, read in part as follows:

> "Section 9. Creation of rulemaking power over antifraud provisions:
>
> The substantive prohibitions of the Investment Advisers Act are very limited. They are in essence contained in sections 205 and 206, which outlaw certain types of unfair investment advisory contracts, and prohibit an investment adviser from perpetrating fraud or from selling securities directly to clients without disclosing the capacity in which he is acting and obtaining the client's consent.
>
> Because of the general language of the statutory antifraud provision and the absence of any express rulemaking power in connection with them, the SEC has always had doubt as to the scope of the fraudulent and deceptive activities that are prohibited and as to how far it is limited in this area by common law concepts of fraud and deceit. These include proof of a (1) false representation of; (2) a material; (3) fact; (4) the defendant must make it to induce reliance; (5) the plaintiff must rely on the false representation; (6) and suffer damage as a consequence.
>
> In order to overcome this difficulty, section 9 of the bill would amend section 206 to add a

prohibition against engaging in conduct which is fraudulent, deceptive or manipulative and to authorize the Commission by rules and regulations to define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative. This is about the identical wording of section 15(c)(2) of the Securities Exchange Act in regard to brokers and dealers.

In the SEC's estimation, such a provision would enable it to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his clients."

The committee reports show that Congress shared that assumption. The House Report, 86th Cong., 2d Sess. No. 2179, says the following:

"Section 9. Addition of rulemaking power to implement antifraud provisions:

Present law.—Present section 206 contains general prohibitions against fraudulent activities.

Problem.—Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in ths area by common law concepts of fraud and deceit.

Remedy in the bill.—It is proposed that a new paragraph (4) be added to section 206 which would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of businesses which are fraudulent, deceptive, or manipulative. This is comparable to section 15(c)(2) of the Securities Exchange Act of 1934 which applies to brokers and dealers."

The Senate Report, No. 1760, U.S. Code Congressional and Administrative News 3502, accepts verbatim the SEC's reasons above quoted (p. 3509) and says generally that, "of the five acts administered by the Securities and Exchange Commission * * * the Investment Advisers Act of 1940 is the most inadequate," p. 3503. Coming to Section 9, it says this would authorize the Commission to issue regulations which would prohibit fraudulent, deceptive, and manipulative conduct," thereby affording a necessary supplement to the "very limited" provisions of §§ 205 and 206 which "outlaw certain types of unfair investment advisory contracts, and prohibit an investment adviser from perpetrating fraud or from selling securities directly to clients without disclosing the capacity in which he is acting and obtaining the client's consent" (p. 3509). Finally, the report says, "This provision would enable the Commission to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his client" (p. 3510).

No proof having been presented under sections 206 (1) and (2) sufficient to justify the granting of a preliminary injunction, the order appealed from is affirmed.

CLARK, *Circuit Judge,* whom Judges SMITH, KAUFMAN, and MARSHALL join, dissenting:

Decision in the present case turns on the meaning and scope of the Investment Advisers Act of 1940, last of the six great regulatory statutes of the era 1933–1940 controlling the marketing of investment securities. We need to recall the dramatic origin of these statutes as an outcome of the greatest stock market crash in history and the exhaustive studies then made of the evils of stock market manipulation

and fraudulent stock selling. It seems universally conceded—and the favorable judicial attitude records the fact—that this legislation was brilliantly successful in responding to a genuine social need. It is a prime demonstration of the capacity of a democratic government to meet a social crisis skillfully and positively. While it may not have solved every problem, it went a long way in facing the issues involved and protecting the investor from being victimized.

After this history of successful achievement it comes as a real shock to find a majority of this court ready to scuttle the last of these highly useful statutes and leave it as but a shell. In a summary opinion which ignores this history and the interconnection of these statutes, they officially declare this Act to be quite ineffective, thus terminating all present regulation of investment advisers and also casting doubt upon the other important acts framed in the same langauge. True, they pay verbal obeisance to the principle that these regulatory laws are to be construed broadly to effectuate their remedial purpose; in actual fact they cut down the operation of the Act's central provision, § 206, 15 U.S.C. § 80b–6, in the very area where its over-all purpose might be furthered. Beyond this the majority show an antagonistic attitude toward securities regulation which bodes ill for the future effectiveness of even the earlier statutes, heretofore generously supported. I believe it fairly demonstrable that so destructive a decision not merely is not compelled, but actually is quite contrary to sound legal principles of statutory interpretation as we have up to now known them.

Initially I find it necessary to set out in greater detail than do the majority the substantially undisputed facts upon which the SEC premised its complaint and motion for a preliminary injunction.

Capital Gains Research Bureau, Inc., a leading registered investment advisory service, published two bulletins which it distributes to subscribers. One, entitled "Facts on Funds," explores changes effected in the portfolio of Mutual Funds; the other, "A Capital Gains Report," is a regular service which periodically evaluates securities. The Capital Gains Report is denominated: "An Investment Service devoted exclusively to (1) The protection of investment capital, (2) The realization of a steady and attractive income therefrom, (3) The accumulation of CAPITAL GAINS thru the timely purchase of corporate equities that are proved to be undervalued." There are about 20,000 subscribers to the "Facts on Funds" bulletin, and about 5,000 subscribers to the "Capital Gains Report"; the latter publication is frequently distributed to a large group of about 100,000 nonsubscribers by use of general mailing lists.

During the period covered in the complaint Capital Gains analyzed several securities and made recommendations to its subscribers concerning them. At the same time, without disclosing the transactions to its customers, it traded in these securities to its profit. The Commission contends that this pattern of secret trading violated the antifraud provisions of the Investment Advisers Act of 1940, § 206 (1) and (2), 15 U.S.C. § 80b-6(1, 2). The transactions were as follows:

(1) On March 15, 1960, Capital Gains purchased 500 shares of Continental Insurance Co. stock at price of \$47¾ and \$47⅞ per share. Three days later it circulated a report recommending purchase of the stock "for gradual but substantial appreciation." For two days after the mailing of the report the volume of trading increased substantially and the market price rose, and on March 29 Capital Gains sold the stock at \$50⅛.

(2) Between May 13 and May 20, 1960, Capital Gains purchased 5,300 shares of United Fruit Co. stock, at a total cost of $117,114.00. On May 27, a report was circulated recommending United Fruit for both long- and short-term gains. Again immediately following the mailing date of the report, trading volume rose markedly and the price increased. (The average daily volume for 11 days preceding the issuance of the report was 5,955 shares; for the 4 days following, average volume was over twice this—13,150.) Between June 6 and June 10, Capital Gains sold the 5,300 shares at a profit of $10,725.00.

(3) On July 5 and July 14, Capital Gains bought 2,000 shares of Creole Petroleum. Then, on July 15, the company issued an optimistic report on Creole. Again volume increased immediately after the report, and again the price rose. Between July 20 and 22, Capital Gains unloaded its shares at a profit.

(4) On August 6, 1960, Capital Gains purchased 600 shares of Hart, Schaffner & Marx stock at $23. On August 12, it issued a report recommending purchase of this security. Again volume increased substantially following the issuance of the report, and the price rose. Within 10 days Capital Gains sold 600 shares at a profit.

(5) Between October 4 and October 13, Capital Gains entered into several transactions involving the stock of the Chock Full O'Nuts Corp. It sold 500 shares short at a net price of $34,200.00. It also purchased 11—3 month "puts." Like the short sale, the purchase of a put reflected a bet by Capital Gains that the price of the stock would decline in the period. On October 14, it sent to its subscribers and others a report comparing the value of Chock Full O'Nuts to that of Frank G. Shattuck Co. (Schrafft's). The report suggested that Chock Full O'Nuts was overvalued.

Again, the day after the report was mailed volume increased and the price, which had been rising, fell and went into a decline; on October 24, Capital Gains covered its short sale at a profit.

(6) Finally, on October 28 and October 31, 1960, Capital Gains purchased a total of 2,000 shares of Union Pacific stock at a price slightly above $25 per share. On November 1, a report was issued recommending this stock. Once again, immediately following the mailing of the report, the volume increased markedly, and the price rose. On November 7, Capital Gains sold the 2,000 shares at 27.[1]

Thus we have evidence of a practice known on Wall Street as "scalping," by which an investment adviser makes a short-term profit on the direct or secondary market reaction to its advice. The question for decision is whether this pattern of undisclosed purchases or short sales of securities shortly before recommendation, invariably followed by a rise in market volume and an appreciable rise or fall in price, followed shortly by sale or cover at a profit, constitutes sufficient evidence to warrant a finding of violation of the antifraud provisions of the Act. It is to prevent this practice that the SEC seeks the mild prophylactic of an injunction, without other penalties or sanctions.

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[1] While the evidence submitted was based on affidavits, the material facts were not denied by an answering affidavit. Here a detailed statement of a prolonged course of conduct was set forth by the Commission; the injunction was sought in the public interest by an independent regulatory body; and the affidavits were clearly sufficient to support a preliminary injunction. Of course the majority really do not deny this, for they accept the facts as stated in their determination of the merits of this appeal. The suggestion that the defendants had to supply the deficiencies of proof seems an unnecessary and irrelevant slur on the activities of a busy and overworked agency.

Here there is no substantial dispute over the facts, and the injunction was denied solely because the district court believed that on these facts no violation of the Investment Advisers Act was made out. This was based on a seriously limiting interpretation of the antifraud provisions of the Act. Thus, as we have often ruled, we must grant full review of this legal determination at this time. See, e.g., *Rings* v. *Spina,* 2 Cir. 148 F. 2d 647, 650, 160 A.L.R. 371; *Carroll* v. *American Federation of Musicians,* 2 Cir., 295 F. 2d 484, 488–489; *Societe Comptoir de l'Industrie Cotonniere* v. *Alexander's Department Stores, Inc.,* 2 Cir. 299 F. 2d 33; *Empresa Hondurena de Vapores, S.A.* v. *McLeod,* 2 Cir., 300 F. 2d 222. It is not a question of finding defendants at fault without awaiting full development of the facts. The uncontroverted facts before us require determination of the scope of the Act. And this is what the majority have done, for the denial of an injunction is grounded not on the state of the record, but on their view of the substantive scope of § 206.

As suggested above, it is necessary to view this legislation against its background, so totally ignored in the majority opinion. Faced with the great stock market crash and accompanying business depression, Congress reacted to the careful studies of stock manipulation before it by passing this series of six great regulatory acts for the protection of the securities investor. These were the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. These statutes form an interrelated pattern of regulation of the securities industry, all of which are essential for the adequate protection of the investor.

One of the chief methods of regulation followed in the several acts was the requirement of full disclosure. In contrast to the common law, which was premised on the ancient maxim *caveat emptor*, the regulatory legislation adopted the philosophy of consumer protection, "let the seller also beware." H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933), quoted in *Wilko* v. *Swan*, 346 U.S. 427, 430. Under this philosophy the seller of securities was required fully to disclose all relevant data, and a variety of devices was fashioned to achieve this end. For example, issuers must file detailed registration statements and circulate accurate prospectuses. Securities listed on an exchange must be registered and reports filed, and those soliciting proxies must disclose certain data. To stiffen and supplement these specific requirements, several antifraud provisions were enacted. Specific penalties and liabilities were provided for failure to disclose the required information. At the same time several general antifraud provisions were passed; among these were § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q (a); §§ 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78o(c) (1); and the sections here under consideration.

These general antifraud sections, which in substantive scope contain many similarities, have been liberally construed to effectuate the broad remedial purpose of the acts. Section 17(a) has been held not to be limited to the narrow confines of common-law fraud. *Charles Hughes & Co.* v. *S.E.C.*, 2 Cir., 139 F. 2d 434, 435–436, certiorari denied 321 U.S. 786; see *Hughes* v. *S.E.C.*, D.C. Cir., 174 F. 2d 969, 974; *Norris & Hirshberg, Inc.* v. *S.E.C.*, D.C. Cir., 177 F. 2d 228; *Archer* v. *S.E.C.*, 8 Cir., 133 F. 2d 795, certiorari denied 319 U.S. 767; *S.E.C.* v. *Torr*, D.C.S.D.N.Y., 15 F. Supp. 315, reversed on other grounds 2 Cir., 87 F. 2d 446, reaffirmed on remand

D.C.S.D.N.Y., 22 F. Supp. 602; 3 Loss, Securities Regulation 1435 (2d Ed. 1961). The common-law doctrines of fraud and deceit grew up in a business climate very different from that involved in the sale of securities, and the rigors of those doctrines were ill fitted to regulation of the sale of this unique and intricate merchandise. See generally Shulman, *Civil Liability and the Securities Act*, 43 Yale L.J. 227 (1933).

The Investment Advisers Act of 1940, the final step in the regulation of the securities market, reflects the purposes and policies of its predecessors. Thus the Senate Committee on Banking and Currency concluded: "The nature of the functions of investment advisers, their increasing widespread activities, their potential influence on security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this committee that protection of investors requires the regulation of investment advisers on a national scale." Sen. Rept. No. 1775, 76th Cong., 3d Sess. 20 (1940).

The majority present an extensive analysis of the "legislative history" of the Act to support their narrow construction of § 206. Very little of this is actually history; and some of that is, as I shall point out later, a misquotation of statements by Professor Loss. The remainder of the extensive discussion is not of history, but of subsequent statements by the SEC and Congress twenty years after the passage of the Investment Advisers Act. Not only are these citations misleading, but reliance on them violates canons of construction laid down by the Supreme Court.

The 1959 statements by the SEC do not support the majority's interpretation of the statute.[2] They do reflect some confusion and concern over the precise scope of § 206, but they never adopt the restrictive interpretation suggested. And it would be naive not to recognize that these statements were made at the close and under pressure of an era of limited initiative and retreat by the regulatory agencies.[3] Even if the SEC had by rule or regulation explicitly adopted a narrow construction of § 206, it would seem highly doubtful that it could thereby defeat the intention of the prior Congress. See *Greene* v. *Dietz,* 2 Cir., 247 F. 2d 689. *A fortiori,* expression of some hesitation or doubt in a later memorandum could hardly have such an effect. Cf. *Wong Yang Sung* v. *McGrath,* 339 U.S. 33, 47-48.

Similarly, the opinions attributed to a Congress twenty years after the event cannot be considered evidence of the intent of the Congress of 1940. There is nothing in the extensive citations of the majority which indicates that the later Congress accepted a narrow interpretation of § 206. The reports merely echo SEC "doubts." Section 206 (4), the 1960 amendment, utilizes language remarkably similar to that of

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[2] Indeed, in 1955, the Commission argued that § 206, "enacted for the specific protection of the investing public," was definitely "not limited to the restrictive concepts of common law fraud." *Seipel* v. *S.E.C.*, D.C. Cir., 229 F. 2d 758, Brief for Appellee, p. 12. This argument was successful; the D.C. Circuit held that § 206 proscribed activity which would not have been actionable at common law. See 3 Loss, Securities Regulation 1516 (2d Ed. 1961).

[3] See, e.g., *Rosenblum* v. *F.T.C.*, 2 Cir., 214 F. 2d 338; *Blau* v. *Mission Corp.*, 2 Cir., 212 F. 2d 77, 81, certiorari denied *Mission Corp.* v. *Blau*, 347 U.S. 1016; *Roberts* v. *Eaton*, 2 Cir., 212 F. 2d 82, 84, certiorari denied 348 U.S. 827; *Greene* v. *Dietz*, 2 Cir., 247 F. 2d 689, 696.

the original statute; the chief material difference is the addition of rule-making power, and it may well be that Congress either rejected the doubts or held no views on the scope of the prior legislation. And even if Congress in 1960 had explicitly commented on the scope of the prior Act, its interpretation would be of little, if any, weight in determination of the meaning of the prior cognate legislation. *Rainwater* v. *United States*, 356 U.S. 590, 593. Thus the data marshaled by the majority prove no more than that a regulatory commission, perhaps sensing a favorable legislative climate, took an opportunity to secure fuller enforcement powers in order to simplify regulation. To determine the intention of the Congress of 1940 we must look backwards from the date of passage, not forwards.

The 1940 Act was designed to protect "the public" "from the frauds and misrepresentations of unscrupulous tipsters and touts" and to safeguard bona fide investment counsel "against the stigma of the activities of these individuals." Sen. Rep. No. 1775, 76th Cong., 3d Sess. 21 (1940). It required registration and prohibited investment advisers from engaging in certain conduct, including that defined in §§ 205 and 206. If, as the majority imply, the statute did not achieve its regulatory purpose, but remained "little more than a census," in Professor Loss's words, this was not due to any deficiency in the antifraud provisions here under consideration, which Loss concludes are very broad reaching, 3 Loss, Securities Regulation 1515 (2d Ed. 1961), but because until 1960 the Commission had inadequate power to inspect the books and records of advisers or to require reports, 2 Loss, Securities Regulation 1408 (2d Ed. 1961). As Professor Loss points out, "a statute of this sort without an inspection power is a statute without teeth." *Ibid.*

The antifraud sections of this statute are substantially similar to, or identical with, § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), and, absent counterindications, should be construed *in pari materia.* Certainly with the earlier Acts before it, Congress would intend identical language to have identical import. Both outlaw use of a "device, scheme, or artifice to defraud" and acts which operate as a "fraud or deceit." Compare clauses (1) and (3) of § 17(a) of the earlier Act with clauses (1) and (2) of § 206 of the later Act. The sole substantial difference between the statute under review and its predecessor is that clause (2) of § 17(a) is not included in the later enactment. Even without explicit statement in the legislative history as to why this clause was omitted, the reasons seem obvious. This clause in essence restates common-law deceit as it was defined in the most liberal jurisdictions, prohibiting obtaining money or property by misleading statements or omissions. See 3 Loss, Securities Regulation 1433–1435 (2d Ed. 1961). It was both necessary and natural to include such a provision in statutes regulating the activities of "dealers" and "brokers." It is irrelevant, however, in the context of regulation of investment "advisers," who by definition do not buy and sell securities for their customers, Investment Advisers Act of 1940, § 202(a)(11), 15 U.S.C. § 80b–2(a)(11), and thus are not normally in a position to obtain money directly by wrongful means. This change not reflecting any material alteration otherwise in the scope of the statute, Investment Advisers Act of 1940, § 206 (1) and (2), 15 U.S.C. § 80b–6(1, 2), should be given the same broad construction, *mutatis mutandis,* as its predecessor. 3

Loss, Securities Regulation 1515 (2d Ed. 1961).[4] And of course it is the recognition that if investment advisers are to "defraud" anyone it will not be in the normal buyer-seller context which is crucial to this case. For it is in the secondary effects of advice, not in direct dealings, that the real potentials for fraud lie in this field. To reach and prevent that is the purpose of this legislation; defrauding in direct dealings is covered by the earlier Acts regulating brokers and dealers.

The majority, verbally emphasizing that the Act should be construed to achieve its remedial ends, recognize that manipulation, if intentional, would come within the scope of the Act. Certainly such activity—whatever it may be held to mean—would not be covered if the statute were narrowly limited. Compare Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b). Having recognized that purposeful manipulation would violate the Act, the opinion then states that there has been insufficient proof here of such activity to warrant granting an injunction. It is utterly unclear to me what further proof is needed. For what could be clearer from the facts as set forth by the SEC than that Capital Gains knew that its recommendations would affect the market and timed their issuance so it would profit therefrom? Cf. *S.E.C.* v. *Torr*, *supra*, D.C.S.D.N.Y., 22 F. Supp. 602, 608.

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[4] It seems a curious inversion of all principles of statutory construction to hold that the omission here of this unnecessary provision is proof of a legislative intent to limit the new Act strictly to the omitted prohibition. This topsy-turvy argument was made and rejected in *Seipel* v. *S.E.C.*, D.C. Cir., 229 F. 2d 758. See 3 Loss, Securities Regulation 1516 (2d Ed. 1961). *Seipel* held that the S.E.C. need not show all elements of common-law fraud to prove a violation of § 206 of the Investment Advisers Act.

"Intent," if it need be found, can certainly be inferred from the facts as stated.

The majority's construction, however, is much narrower, for the gist of the opinion is that even intentional, secret manipulation is lawful if it is not "artificial." Thus it seems that an adviser can escape liability for scalping unless the SEC affirmatively proves he disbelieved his own recommendations. Since there are many creditable stocks upon which a plausible analysis can be built, such a burden will be almost impossible for the Commission to meet.

Not only is this construction inconsistent with the Congressional intent to regulate the effect of advisers on the markets and on unsuspecting customers and with the settled trend of interpretation of parallel antifraud provisions; it also conflicts with the holding of one of the chief cases on which the majority itself relies, *S.E.C.* v. *Torr,* D.C.S.D.N.Y., 15 F. Supp. 315, 317, reversed on other grounds 2 Cir., 87 F. 2d 446, reaffirmed on remand D.C.S.D.N.Y., 22 F. Supp. 602.[5]

Capital Gains violated its duty to disclose its secret trading. In a case brought prior to the passage of the 1940 statute the D.C. Circuit held that an investment adviser is in a fiduciary relationship with his clients and violates the antifraud sections of the 1933 and 1934 Acts by failing to reveal that he simultaneously exercised the role of broker-dealer, thus gaining a material interest in their response to his advice. *Hughes* v. *S.E.C., supra,* D.C. Cir., 174 F. 2d 969. And in *Charles Hughes & Co.* v. *S.E.C., supra,* 2 Cir., 139

[5] In reversing the grant of a preliminary injunction, this court did not question the existence of a statutory violation, but held that, since the defendants had ceased engaging in the questioned practices and gave no indication of resuming them, the injunction was improvidently granted. On remand, Judge Woolsey reaffirmed the holding that the defendants' conduct violated § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a).

F. 2d 434, 437, certiorari denied 321 U.S. 786, we held that a registered broker-dealer which had secured the confidence of its customers in the reliability of its recommendations committed statutory fraud by withholding the fact that the price charged its customers was above the prevailing market. "Once that confidence was established, the failure to reveal the markup pocketed by the firm was both an omission to state a material fact and a fradulent device."

Here Capital Gains held itself out as an investment adviser and stated that the service was exclusively designed to help clients protect investment capital, realize income, and accumulate capital gains. It thus naturally installed in its clients the belief that it would render impartial and unbiased expert advice. Having taken this fiduciary stance, it then secretly engaged in profitable trading operations often inconsistent with its own advice. These operations were dependent for their success on client and general market reaction to the advice, and thus gave Capital Gains a motive to encourage purchases by its clients, regardless of the stock's intrinsic merit. Failure to disclose the existence of such a motive in the light of the implicit and explicit guaranty of impartiality was a scheme to defraud and operated as a fraud upon the clients.

Thus the majority's approving citation of *S.E.C.* v. *Torr, supra,* D.C.S.D.N.Y., 15 F. Supp. 315, is strange. For the finding of a statutory violation there is equally applicable in this case. In *Torr,* defendants were paid a bonus for all activity in a particular stock on the New York Curb Exchange which could be fairly attributed to the effects of their influence in touting the security. The court held that they committed statutory fraud when, in honestly recommending a perfectly good security, they suppressed the fact that they had such a direct financial interest in induc-

ing clients to rely on their advice. The economic situation in this case is precisely the same.

Some of my brothers seemingly draw some comfort in believing that the destructive effect of this construction of the statute will be limited in effect and duration because of powers now granted to the SEC by the 1960 amendment to the statute, § 206(4), 15 U.S.C. § 80b–6(4). That amendment adds another prohibition which makes it unlawful for advisers to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative," and authorizes the SEC to issue rules and regulations defining and prescribing means to prevent such behavior. The thought seems to be that the SEC will hereafter outlaw the defendants' activities by regulation. This suggests an easy solution to a problem which is obviously bemusing the court. But like many an "easy" solution it becomes in reality the harder one because of the difficulties it creates. Among those difficulties are those of time, of power and validity of the indicated action, of legislative policy in the premises, and of potential paralysis of agency action and the execution of Congressional policies.

On the matter of time it is obvious that under the most favorable conditions—that even if it be eventually adjudicated that the SEC can declare activities criminal which the court now holds perfectly legal—it will be several years before any regulation hitting the defendants' practices can be properly drafted, enacted, and then upheld judicially. Obviously not in our generation can any effective regulation along this line be expected. As counsel pointed out in argument, the mere drafting is a matter requiring time and unusual skill, even before the product is submitted to public scrutiny through official hearings and other means. In the two regulations it has adopted under this new statute the SEC has wisely limited

itself to means and devices to effectuate what it accepts as the declared policy of the statute and is not making new policy. One of these, SEC release No. 120, Oct. 16, 1961, requires registration of stock dealings by advisers *and their staffs,* thus giving it information as to the persons actually engaged in the investment counseling; while the other, SEC Release No. 121, Nov. 2, 1961, deals with *advertising* by investment advisers and is aimed to prevent advertising contrary to the statutory intent, i.e., fraudulent, deceptive, or manipulative. Neither of these would reach defendants' practices here; to do so would require a change in SEC policy, not merely to implement Congressional bans, but itself to initiate and define a ban and make it operative.

And that leads to the difficult problem of validity of such a prohibition. In *Greene* v. *Dietz, supra,* 2 Cir., 247 F. 2d 689, we were troubled by the power of the SEC to make regulations not authorized by Congress or possibly contrary to the Congressional mandate. That question, which we did not try to resolve definitively, would arise in acute form here in view of the decision that scalping is a permitted and uncriticizable practice under present legislation. This, as I have indicated, means in substance that only common-law fraud, i.e., misrepresentation relied on to one's loss, is interdicted by the provisions of § 206 (1) and (2).[6]

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[6] The panel opinion by Judge Moore, 2 Cir., 300 F. 2d 745, has been adversely cited by commentators as indicating, *contra* to settled and uniform authority, that the antifraud provisions of the Securities Acts are limited to the narrow elements of common-law fraud. This is the position taken by Professor Loss in the 1962 Supplement to his treatise, 3 Loss, Securities Regulation 1435 n. 19 (1962 Supp.), and by Note, 75 Harv. L. Rev. 1449, 1450 n. 6 (1962). See also Note, 71 Yale L.J. 1342, 1347 (1962). While the majority opinion here is more guarded as to rationale and more generous in disclaiming illib-

What is changed under the new amendment? Obviously the words "fraudulent" and "deceptive" add nothing more; the only addition is the word "manipulative." But it is difficult to perceive how a court which does not regard scalping as fraudulent can conceive of it as manipulative; it must believe that the practice amounts only to ordinary buying and selling in the natural course of business. There thus would be serious question as to the validity of a regulation prohibiting and making criminal practices not prohibited by Congress—a question needless to say which does not arise under what seems to me the more natural interpretation of the Congressional purpose which I urge.

The other two objections I shall discuss together more hurriedly. In both the original and the amended additional form of the statute, the prohibition (whatever its meaning) is made direct and unequivocal: "it *shall be unlawful* for any investment adviser" subject to the Act to engage in the fraudulent, deceptive, or manipulative act, practice, or course of business. The mandate is not made subject to the condition precedent of some validating action by the SEC; it cannot add to or subtract from the Congressional action. When Congress wished to provide such a condition precedent it knew how to do it. Thus in § 10(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(a), it made unlawful the use of means to effect a short sale "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

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erality than its predecessor, the effect of the opinion is precisely the same. Moreover, no attempt is made to distinguish the language of § 206 from identical phrases in the other anti-fraud statutes and rules.

And in subdivision (b) it enacted a like provision as to manipulative or deceptive devices or contrivances in connection with the purchase and sale of any securities. The addition by way of gloss here of such a condition precedent suggests a general rule (there being no special reason for limiting it to the present case) which would go well beyond this case in destructive possibilities. Now in general the regulatory agencies seek injunctions to effectuate legislative policy;[7] if first there must be some definite and precise agency regulation the execution of Congressional policy will be hampered and delayed, if not made impossible.

In short, the hope of a regulation which will require Capital Gains to meet appropriate fiduciary standards not contained in the statute is illusory indeed. I see no ameliorating factor to lessen the harshness of the decision, and am completely at a loss to understand the reason for it. As I have indicated, it is not a required result; actually the contrary would have been much simpler under the precedents, particularly because of the troublesome doubt now

[7] All of the six securities acts contain provisions authorizing injunctive relief without conditions, such as are here being formulated. See, e.g., Securities Act of 1933 § 20, 15 U.S.C. § 77t; Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa; Investment Advisers Act of 1940, § 209, 15 U.S.C. § 80b-9. Many, perhaps most, other statutes administered by government agencies authorize injunctive relief. See, e.g., Agricultural Adjustment Act, § 8a(6), 7 U.S.C. § 608 a(6); Civil Aeronautics Act of 1938, § 1007, 49 U.S.C. § 647; Communications Act of 1934, § 401, 47 U.S.C. § 401; Federal Trade Commission Act, § 13, 15 U.S.C. § 53; Interstate Commerce Act, § 16(12), 49 U.S.C. § 16(12); Labor Management Relations Act of 1947, § 101(*l*), 29 U.S.C. § 160(*l*). Arguments against a required rule-making in this connection are stated in 75 Harv. L. Rev. 1449, 1451 (1962), discussing *Cady, Roberts & Co.*, SEC Release No. 6668, Nov. 8, 1961.

cast upon the meaning of the antifraud provisions of the Securities and Securities Exchange Acts. Perhaps its worst feature is that it sanctions and indeed endorses a low standard of business morality, as the business world has apparently been quick to see.[8] The form of scalping here engaged in is a shocking business, as well as the chief method by which an investment adviser may bilk his clients. This regulatory statute was explicitly aimed to protect the loyal investment adviser against the tipsters and touts and the less desirable members of the profession generally. In all probability it will be those devoted fiduciaries who will be hardest hit by this decision which levels all to one low standard. By holding scalping not a violation of § 206 (1) and (2), the majority not only have sadly emasculated a promising statute, but have also cast doubt generally upon all governmental regulation in the general public interest.

I therefore reiterate the position I took in dissenting initially from the decision of the panel majority, 2 Cir., 300 F. 2d 751–754. I believe the decision below should be reversed, and an injunction *pendente lite* granted.

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[8] See the syndicated columns of the financial writer Sylvia Porter in the New York Post for Jan. 4, 1962, "Stock 'Scalping' Upheld by Court"; Jan. 5, 1962, "Investment and Ethics"; and Feb. 16, 1962, "Stock 'Scalping' Faces Court Test." Cf. Leslie Gould, Financial Editor, "SEC Puts Postscript on 'You Only Have to Get Rich Once' Book," N.Y. Journal-American, May 24, 1962, p. 29.

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 26942

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLANT,

v.

CAPITAL GAINS RESEARCH BUREAU, INC., AND HARRY P. SCHWARZMANN, DEFENDANTS-APPELLEES

Before LUMBARD, *Chief Judge,* and CLARK, WATERMAN, MOORE, FRIENDLY, SMITH, KAUFMAN, HAYS, and MARSHALL, *Circuit Judges.*

Appeal from the United States District Court for the Southern District of New York.

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of July, one thousand nine hundred and sixty-two.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed.

A. DANIEL FUSARO,
Clerk.

APPENDIX C

1. The Securities Act of 1933 (48 Stat. 74, 84, 15 U.S.C. 77a, *et seq.*) provides in pertinent part:

> An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.
>
> * * * * *
>
> FRAUDULENT INTERSTATE TRANSACTIONS
>
> SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
>
> * * * * *

2. The Securities Exchange Act of 1934 (48 Stat. 881, 891, 895, as amended, 15 U.S.C. 78a *et seq.*) provides in pertinent part:

An Act to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

* * * * *

REGULATION OF THE USE OF MANIPULATIVE AND DECEPTIVE DEVICES

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * * *

OVER-THE-COUNTER MARKETS

SECTION 15.

* * * * *

(c)(2) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, in connection with which such broker or dealer

engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation. The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

* * * * *

3. Rule 10b-5 (17 C.F.R. 240.10b-5) issued pursuant to the Securities Exchange Act of 1934 provides:

Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

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